Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:SEA:POR:TL-N-6595-00
JMDewey

date: January 16, 2001

to: John Barrett, Revenue Agent
LMSB Group 1293, Eugene

from: Associate Area Counsel, LMSB
Seattle/Portland

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subject: **Proposed Adjustments: I.R.C. Sections 269 and 382**

Taxpayer: [redacted]

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INTRODUCTION

You have requested our advice regarding the disallowance of a net operating loss (NOL) carry-forward set out in a notice of proposed adjustment (NOPA) for the above-named taxpayer for tax years ending [redacted]. In addition to our opinion on the legal basis for the proposed adjustments, you have asked for our suggestions concerning further factual development of the issues.

The adjustments you propose are valid ones. [redacted] to [redacted], we [redacted] concur with your conclusion that the NOL deductions at issue should be disallowed under I.R.C. § 269. [redacted].

We also agree with your alternate position, that the NOL deductions may be disallowed, in large part, pursuant to I.R.C. § 382. As you know, the key factual element to be establish here is whether there was a greater than 50% change in ownership as a result of the merger. In the present case, this will depend upon the nature and extent of the ownership interests in [redacted] held by different stockholders during the three-year testing period prior to the acquisition--in particular, when stockholder [redacted] obtained a substantial indirect interest in [redacted] by acquiring an interest in [redacted]. [redacted].

FACTUAL BACKGROUND

The transaction at issue is the [redacted] acquisition by [redacted] ([redacted]) of the assets of [redacted] ([redacted]). For tax purposes, this was a statutory merger under I.R.C. § 368(a)(1)(A). After the acquisition, the merged corporation changed its name to [redacted]. Subsequently, it claimed deductions for NOL carry-forwards of approximately $[redacted] in [redacted], $[redacted] in [redacted], $[redacted] in [redacted], $[redacted] in [redacted] and $[redacted] in [redacted]. Your proposed adjustments are for the taxable years ending in [redacted] and [redacted].

Merger documents provided by the taxpayer state that, in addition to the possibility of offsetting some of [redacted]'s NOLs against [redacted]'s [redacted] income, the business purposes for the [redacted] merger were: (1) to consolidate operations and thus reduce costs, (2) to use [redacted]'s expertise in real estate to "maximize the value" of [redacted]'s real estate holdings, and (3) to provide additional capital to "sustain" [redacted]'s real estate investment operations "until the real estate market in Arizona improves."

A. [redacted]. At the time of the acquisition, [redacted] was primarily engaged in activities relating to real estate; most of its income came from fees for the management of undeveloped land, some of which it held ownership interests in. Gross income for the [redacted] years prior to the merger averaged $[redacted] per year, and was declining. [redacted]'s real estate interests were appraised at $[redacted] in [redacted]. At that time the company also held stock in [redacted] other companies, [redacted]'s

[redacted] (valued at $[redacted]) and [redacted] (valued at $[redacted]). [redacted] carried on its books approximately $[redacted] in NOLs, most of which had been incurred prior to [redacted], when its predecessor corporation had been engaged in the brokerage of [redacted]. In [redacted] the tax benefit of these NOLs was valued at $[redacted], based, in part, on the future income which might be offset before [redacted], when most of the NOLs would expire for tax purposes.

At the time of the acquisition, [redacted] had one (part-time) employee, [redacted], its Chief Executive officer. According to merger documents, the stockholders with direct ownership interests in [redacted] were [redacted] ([redacted]%), [redacted] ([redacted]%) and an entity called [redacted] ([redacted]%). Approximately [redacted]% of the company was owned by others whose individual interests were less than 5% (this included [redacted]% owner, [redacted]).

The taxpayer asserts that, at the time of the merger, [redacted] ("an undocumented joint venture") was owned [redacted]% by [redacted] and [redacted]% by [redacted]. However, it is unclear at what point in time [redacted] obtained this interest in [redacted]--and thus obtained a substantial indirect interest in [redacted]. The taxpayer asserts that this occurred in [redacted], but has failed to provide documentation to show that it happened prior to [redacted]. Instead, the [redacted] Form 10-K filed by [redacted] with the Securities and Exchange Commission (SEC) lists neither [redacted] nor [redacted] among the owners holding a beneficial interest of more than 5% in [redacted] as of [redacted]. ([redacted]'s beneficial interest is listed there as [redacted]%.) Copies of [redacted]'s stock record book and its Forms 10-K and 10-KSB for the fiscal years [redacted], [redacted] and [redacted], which should provide detailed information on [redacted]'s ownership for those years, have been requested but not provided by the taxpayer.

B. [redacted]. In [redacted], the business of [redacted] was the ownership and management of [redacted] restaurants. Generally, it owned the buildings and the land on which these [redacted] were located, but had no other real estate holdings. Gross income for the three years prior to the merger averaged $[redacted] per year. The assets of [redacted] were valued at $[redacted] in [redacted]. The co-Chief Executive Officers were [redacted] and [redacted]. [redacted] owned [redacted]% of the stock directly and [redacted]% indirectly (through [redacted]), [redacted] owned [redacted]%, [redacted] [redacted]%, [redacted] [redacted]%, and approximately [redacted]% was owned by others whose individual interests were less than 5%.[1]

[1]None of these minor stockholders held ownership interests in [redacted].

DISCUSSION

A. The Adjustments Based on Section 269:

As you have discussed in your NOPA, under circumstances where one corporation acquires the assets of another corporation (not previously controlled), in order to obtain tax benefits that it would otherwise not have enjoyed, the Service may disallow the claimed benefits under Section 269(a). In order for these benefits (credits, deductions, or other allowances) to be disallowed, however, the facts and circumstances must show that the principal purpose for the acquisition of the target corporation was the evasion or avoidance of Federal income tax.

In the present case, the tax benefits under consideration are the possible carry-forwards of NOLs held by the acquiring corporation ([redacted], the "loss corporation"); and it is the assets of the target corporation ([redacted]) which generate the income to be offset. Although, as the NOPA points out, section 269(a) has most frequently been applied in situations where a profitable corporation acquires a loss corporation, case law demonstrates that the section will also apply in the opposite situation--where, as here, the loss corporation acquires a profitable one in order to utilize carry-overs of its own NOLs. See, for example, Vulcan Materials Co. v. U.S., 446 F.2d 690 (5th Cir. 1971), and related cases.

Also as you have noted, in considering the question of control, that is, whether the acquiring corporation or its shareholders had control of the target corporation immediately prior to its acquisition, no attribution rules apply; only the direct ownership of stock may be considered. Brick Milling Co. v. Commissioner, T.C. Memo. 1963-305; Rev. Rul. 80-46, 1980-1 C.B. 62. Thus, because no individual or entity directly owned 50% or more of [redacted] just prior to its acquisition, neither [redacted] or any of its stockholders had "control" of it, within the meaning of section 269. Thus, the "exception" to the application of section 269, which is set out in subsection (a)(2) of that section, does not apply.

It follows that the key element which must be demonstrated (b)(7)a [redacted] in this case is whether the principal purpose for the acquisition of [redacted] by [redacted] was to gain the benefit of substantial NOL carry-forwards, or if the other business purposes recited by the taxpayer in its merger documents were of real substance or significance. A "principal purpose" is one that exceeds in importance any other purpose. I.R.C. § 1.269-3(A). Thus, it is possible that where bona fide business purposes exist, they may be held to comprise the "principal" reasons for a merger, even where a transaction contains elements of tax evasion or avoidance. The determination of the purpose behind an acquisition requires the

examination of the entire circumstances under which it occurred. Hawaiian Trust Co., Ltd. v. Commissioner, 291 F.2d 761 (9th Cir. 1961).

The first business purpose recited by the taxpayer was to reduce costs by consolidating the operations of the two corporations. However, it appears that the same administrative offices and the same employee positions were maintained after the merger as had been maintained prior to it. Before the merger both [redacted] and [redacted] had offices in Phoenix, and the [redacted] business maintained an administrative office in Oregon. There was no change after the merger. Before the merger, [redacted], by himself, managed [redacted]'s real estate investment business on a part-time basis out of his Phoenix office, and was also a co-Chief Executive Officer for the [redacted] business. He continued to act in these capacities after the merger. Thus, any reduction of management costs that might have resulted from the merger appear to have been minimal, at best. (b)(7)a [redacted] (b)(7)a [redacted].

The second reason given for the merger was to make available to the [redacted] business [redacted]'s real estate expertise. Once again, however, no change resulted from the merger, since the tax expertise of [redacted], [redacted]'s sole employee and executive, was fully available to the [redacted] business before the merger, as he was one of [redacted]'s Chief Executive Officers. Also, of course, [redacted] had no investments in real estate except for the ownership of those parcels on which its [redacted] were located. (b)(7)a [redacted] (b)(7)a [redacted] (b)(7)a [redacted].

The third business purpose alleged for the merger was to provide additional capital to [redacted] so that it could hold onto its real estate investments until such time as the market for them improved. However, it appears that [redacted]'s real estate activities have not changed as the result of the merger, and no new capital has been invested in these activities. This is not surprising, since merger documents describe [redacted]'s capital requirements as "modest"--the corporation had no material commitments or requirements for capital expenditures at that time. It is likely that most, if not all, of the expenses of the operation (including [redacted]'s salary and the costs to hire consultants on an as-needed basis) have always been paid out of management fees received. (b)(7)a [redacted] (b)(7)a [redacted] (b)(7)a [redacted].

In our opinion, the evidence so far provided convincingly indicates that the purpose for this acquisition which exceeds in importance any of the other alleged purposes, was to enable the merged company to claim the benefit of substantial NOL carry-forwards which would otherwise not have been of any use to [redacted], should the merger not have taken place.

B. The Adjustments Based on Section 382:

I.R.C. § 382, as amended by the Tax Reform Act of 1986, provides a limitation on the amount of corporate income generated after an ownership change that may be offset by carry-forwards of NOLs incurred prior to such change. An "ownership change" which triggers the application of this statute is one which involves a greater than 50% change in the ownership of the stock of the loss corporation. I.R.C. § 382(g) Generally, the test for ownership change involves a computation for each stockholder owning 5% or more of the stock of the "old" loss corporation, based on stock value. I.R.C. § 382(k)(6). The base point for determining the percent of increase in ownership is the lowest percentage of stock owned by a given stockholder at any time during a "testing period," which generally is the three years prior to the alleged qualifying change. I.R.C. § 382(i). Stockholders owning less than 5% of the stock of the "old" loss corporation will be grouped together and treated as one stockholder for purposes of the test. I.R.C. § 382(g)(4). Although the change in ownership calculation required by the statute may be complicated, I.R.C. § 1.382-2T (c) and (e) set out step-by-step methods which can be used to make these calculations. Under I.R.C. § 1.382-2T(k)(1)(i), a loss corporation is required to keep all the records necessary to identify its shareholders and determine their ownership interests for purposes of this section.

Unlike the question of "control" which arises under section 269, the evaluation of ownership change under section 382 includes indirect, beneficial ownership, and the attribution rules of I.R.C. § 318 apply. Thus, stock owned by a corporation is attributed to the shareholders of that corporation.

In requesting our advice on this matter, you indicated that the taxpayer has disagreed with only one aspect of your section 382 ownership analysis, and this is the determination of the lowest percentage of stockholder [redacted]'s ownership interest in [redacted] during the three year testing period prior to the merger, which you have determined was [redacted]%. The taxpayer asserts that at all times during this period, [redacted] owned [redacted]% of [redacted], which held approximately [redacted]% of [redacted]'s stock. Thus, taxpayer alleges, [redacted] also held a [redacted]% indirect interest in [redacted]. The taxpayer has offered to provide sworn statements from [redacted] and [redacted] to this effect, but has provided no records or documents in support of

this claim.

We support your position that it is the taxpayer's responsibility to provide the documents and records to substantiate the ownership question at issue here. (b)(7)a [redacted] (b)(7)a [redacted] the documents you have obtained (such as [redacted]'s pre-acquisition Federal tax returns and its [redacted] Form 10-K filed with the SEC) provide evidence which supports your ownership analysis. (b)(7)a [redacted] (b)(7)a, (b)(5)(AC) [redacted] (b)(7)a [redacted].

If you have any questions or comments about the above, please call the undersigned at (503) 326-3100, extension 248.

Julia M. Dewey

JULIA M. DEWEY
Attorney